



EX PARTE BY LATE FILED

4341 PIEDMONT AVENUE
P.O. BOX 11080
OAKLAND, CALIFORNIA 94611
(510) 428-2225
FAX (510) 428-0151

BUCKET FILE COPY ORIGINAL

October 11, 1996

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Room 222
1919 M Street N.W.
Washington D.C. 20554

RECEIVED
OCT 15 1996
FCC MAIL ROOM

Re: CC Docket 96-149, Non-Accounting Safeguards

Dear Mr. Caton:

On October 11, 1996, Jeffrey Sinsheimer, Director of Regulatory Affairs, and Lesla Lehtonen, Assistant General Counsel, California Cable Television Association, sent the attached letter to Mr. A. Richard Metzger.

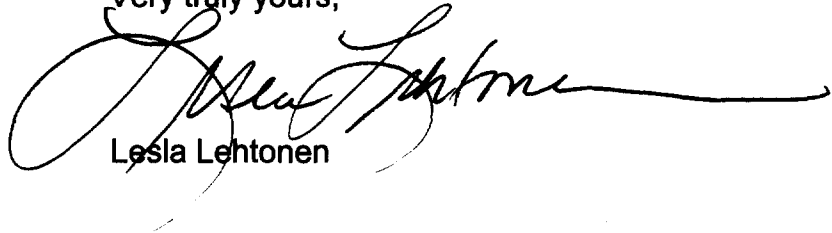
Pursuant to Section 1.1206(a)(1) of the Commission's Rules, two copies of this written document are attached for inclusion in the public record in the above-captioned proceeding.

No. of Copies rec'd
Date A G O E

021

Should you have any questions regarding this matter, please contact me.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Lesla Lehtonen', with a long horizontal flourish extending to the right.

Lesla Lehtonen

Attachment

cc. John Nakahata
James Coltharp
Regina Keeney
Carol Matthey
Cheryl A. Leanza
Linda Kinny
Lauren Belvin
Daniel Gonzalez

DOCKET FILE COPY ORIGINAL



EX PARTE OR LATE FILED

4341 PIEDMONT AVENUE
P.O. BOX 11080
OAKLAND, CALIFORNIA 94611
(510) 428-2225
FAX (510) 428-0151

DOCKET FILE COPY ORIGINAL

RECEIVED
OCT 15 1996

October 11, 1996

FCC MAIL ROOM

A. Richard Metzger Jr.
Common Carrier Bureau
Federal Communications Commission
1919 M Street
Washington D. C. 20554

Re: CC Docket 96-149, Non-Accounting Safeguards

Dear Richard:

We appreciated the opportunity to speak with you regarding CCTA's concerns in the above-referenced docket in the context of Pacific Bell's proposal to have its long distance affiliate, Pacific Bell Communications ("PB Com") provide local service. We are enclosing a copy of the testimony filed by Marvin Kahn at the California Commission in the proceeding determining the authority of PB Com, which elaborates on CCTA's concerns.¹

Both legal and policy questions are posed by the non-structural separation of local and long distance provided by the BOC affiliate. It is true that the Telecommunications Act of 1996 does not expressly address the provision of local service, either on a resale or facilities basis, by the BOC long distance affiliate. However, Section 272 does clearly dictate that in-region long distance provided by a BOC must be provided through a separate subsidiary. This requirement and other safeguards in the Act provide this mechanism for structural separation in order to ensure a pro-competitive transition in the evolving local exchange market (See Kahn at 15, 16, lines 19 - 23 and 1 - 7 respectively);

¹Testimony was also filed by Mr. Thomas Catlin, which illustrates the concerns expressed by Dr. Kahn with evidence obtained in discovery. However, because Mr. Catlin's testimony contains proprietary information, we have not enclosed it, other than a brief explanation as to why affiliate transaction rules do not prevent monopoly abuses in this situation.

Section 272(g)(1) of the Act does provide for joint marketing by the BOC and its affiliate. Joint marketing however, is very different than actually providing local service of one's own, whether provided through resale or on a facilities basis. In fact, a consistent reading of Section 272(g)(1) with 272(g)(2) is only possible if those provisions are read as only relating to joint marketing.

There is also a strong policy argument that the BOC affiliate not be allowed to provide local service as a reseller or as a facilities-based carrier. PB Com, in this case, could still engage in joint marketing offerings. The proposed structure of Pacific and PB Com allows Pacific Bell and PB Com to act in concert. This structure permits Pacific Telesis to draw on the Pacific Bell's position as a monopoly provider of regulated local services to advantage its unregulated affiliate, PB Com. As Dr. Kahn's testimony indicates, Pacific's proposed structure allows:

- * PB Com to become the provider of Pacific Bells high-value, high volume customers, to the detriment of the remaining customers of the regulated entity (Kahn, at 6, lines 6 - 8);


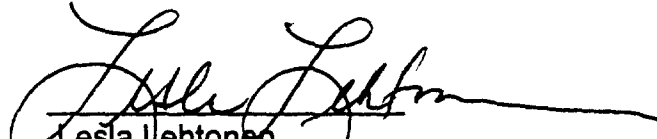
- * Pacific to achieve the ability to escape the anticompetitive safeguards imposed on the BOCs by the States, such as price floors and imputation (Kahn at 7, lines 16 -18)

- * Pacific to be able to abuse its control of CPNI information for the benefit of its affiliate (Kahn at 8, lines 9-18),.

As Dr. Kahn and Mr. Catlin point out, affiliate transaction rules focus on cost allocation and transfer pricing issues, matters relevant to rate of return regulation. Thus the affiliate transaction rules are ineffective in addressing the structural concerns here, and the commingling of PB Com and Pacific. At a bare minimum, the FCC must act to ensure that BOCs are not permitted to transfer hard assets (e.g., switches or subscribers), or intangible assets, (e.g., intellectual property) to unregulated affiliates. These steps, along with affirmation of the legal analysis in paragraphs 72 through 79 of the NPRM, and, in particular, a firm statement that the law requires separation of affiliates providing local and in-region long distance services, will achieve the pro-competitive goals that Congress intended in creating Section 272.

We are hopeful that Dr. Kahn's testimony will provide you with a concise statement regarding CCTA's concerns. Please do not hesitate to contact Jeffrey Sinsheimer or Lesla Lehtonen at 510-428-2225 with any questions. We welcome any further opportunity to discuss this issue.

Very truly yours,


Jeffrey Sinsheimer
Lesla Lehtonen

cc:

John Nakahata
James Casserly
Daniel Gonzalez.
Lauren Belvin
James Coltharp
Regina Keeny
Carol Matthey
Cheryl A. Leanza
Linda Kinny

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

RECEIVED

OCT 15 1996

FCC MAIL ROOM

In the Matter of Pacific Bell)
Communications for a)
Certificate of Public Convenience)
and Necessity to Provide)
interLATA, intraLATA)
and Local Exchange Tele-)
communications Services)
Within the State of California)

Application No. 96-03-007

DIRECT TESTIMONY

OF

DR. MARVIN H. KAHN

ON BEHALF OF

THE CALIFORNIA CABLE TELEVISION ASSOCIATION

OCTOBER 1996

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

In the Matter of Pacific Bell)	
Communications for a)	
Certificate of Public Convenience)	
and Necessity to Provide)	Application No. 96-03-007
interLATA, intraLATA)	
and Local Exchange Tele-)	
communications Services)	
Within the State of California)	

DIRECT TESTIMONY

OF

DR. MARVIN H. KAHN

I. INTRODUCTION

1 Q. PLEASE STATE YOUR NAME, ADDRESS AND PLACE OF EMPLOYMENT.

2 A. My name is Marvin H. Kahn. I am founding principal of Exeter Associates, Inc. Our
3 offices are located at 12510 Prosperity Drive, Silver Spring, Maryland 20904.

4 Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

5 A. My name is Marvin H. Kahn. I am a Senior Economist and a founding principal of
6 Exeter Associates, Inc. Our offices are located at 12510 Prosperity Drive, Silver Spring,
7 Maryland 20904.

8 Q. PLEASE REVIEW YOUR BACKGROUND AND QUALIFICATIONS.

9 A. I am an economist specializing in public utility regulation, energy, communications and
10 antitrust analysis. My primary research interest is in the application of microeconomic

1 principles to public policy issues. Over the last several years, my interests have turned
2 most specifically to matters regarding the regulation of firms operating simultaneously in
3 competitive and non-competitive markets. Particular issues addressed include the
4 unbundling of services, the effects of imposing line of business restrictions on regulated
5 firms, assessments of alternative regulatory structures, and matters regarding cost
6 allocation and rate design.

7 In addition to my consulting experiences, I taught economics or lectured at the University
8 of Tennessee, at the University of Missouri in St. Louis, at Washington University in St.
9 Louis, at Merrimac College and at The Johns Hopkins University. I served as a senior
10 economist with the Institute of Defense Analysis and the Mitre Corporation, both not for
11 profit Federal Contract Research Centers in the Washington, D. C. metropolitan area. I
12 also served as a senior staff economist with an Ad Hoc Committee of the U.S. House
13 Committee on Currency and Banking, focusing on energy and employment issues.

14 I am a graduate of Ohio Northern University and hold a Ph.D. in Economics from
15 Washington University in St. Louis.

16 Q. HAVE YOU TESTIFIED BEFORE REGULATORY AUTHORITIES ON MATTERS
17 DEALING WITH TELECOMMUNICATIONS?

18 A. Yes. I have served as an expert witness on matters regarding telecommunications before
19 commissions in over 20 jurisdictions in this country and Canada. In addition, I served or
20 am now serving as a consultant on regulatory policy or ratemaking issues to 10 state
21 regulatory commissions. I have also undertaken research and prepared reports on
22 ratemaking issues for the U.S. Postal Service, the National Association of State Utility

1 Consumer Advocates (NASUCA), the FCC and the National Regulatory Research
2 Institute (NRRJ).

3 Q. HAVE YOU TESTIFIED BEFORE THE CALIFORNIA PUBLIC UTILITIES
4 COMMISSION (CPUC) ON ISSUES INVOLVING THE COMMISSION'S OWN
5 MOTION INTO COMPETITION FOR LOCAL EXCHANGE?

6 A. Yes. I have testified on issues involving pricing rules and safeguards in R.95-04-043,
7 I.95-04-044, Phase II, Docket No. R95-01-020 and Docket No. 93-04-003. A copy of my
8 resume is attached as Exhibit 1.

9 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

10 A. Exeter Associates has been asked by the California Cable Television Association (CCTA)
11 to review and comment on the Application of Pacific Bell Communications (PBCom) for
12 a Certificate of Public Convenience and Necessity to enter the interLATA
13 telecommunications market in California and to address the appropriate regulation for the
14 affiliate of Pacific Bell. Specifically, I have been asked to address the best regulatory
15 policy for PBCom consistent with achieving the goal of promoting competition and a
16 competitive outcome in the markets for telecommunications services in California. My
17 associate, Mr. Catlin, examines the proposed relationship between PBCom and Pacific
18 Bell.

II. SUMMARY AND CONCLUSIONS

Q. PLEASE DESCRIBE THE PBCOM APPLICATION FOR A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY.

A. In its application, PBCom is requesting certification to permit it to provide interLATA, intraLATA and local exchange telecommunications services in California. The application is silent as to whether PBCom intends to function as a reseller or as a facilities-based provider, but indicates that PBCom is seeking the authority to function in either or both capacities (Paragraph 7).

PBCom has indicated in response to data requests that it will initially provide service as a reseller, and that with respect to interLATA services, it has reached an agreement with Sprint. The terms or other information on how PBCom will obtain and/or provide local exchange and intraLATA toll services are not available. PBCom has further indicated in responses to data requests that it currently has no written agreement with Pacific Bell or any other provider of local or intraLATA services.

PBCom is a wholly-owned subsidiary of Pacific Telesis. It is the intent of PBCom to serve as the Bell operating company affiliate of Pacific Bell under Section 272 of the Telecommunications Act of 1996 (Act). That is, assuming that checklist requirements of Section 271 of the Act are met, PBCom seeks to become the affiliate provider of in-region interLATA services as well as a provider of local exchange telecommunications services and intraLATA toll services.

PBCom also requests that it be classified as a non-dominant carrier since, according to PBCom, it will "start business with no existing customer base and, thus, no market

1 share.”¹ PBCom seeks authority to provide these services “without limitations”² and
2 plans to jointly market (or bundle) local, intraLATA toll and interLATA services.
3 PBCom plans to offer “attractively priced bundled service”³ by discounting, including
4 discounts on its interLATA services, as part of its bundled services offerings. PBCom
5 currently has no plans to deaverage rates for its local exchange service and does not
6 expect to request Carrier of Last Resort status.⁴

7 Q. HOW DOES PBCOM EXPECT TO MARKET ITS SERVICES?

8 A. PBCom has indicated that it expects Pacific Bell to be a major factor in the marketing and
9 sale of its interLATA services. PBCom estimates that 50-60 percent of its interLATA
10 services will be sold by Pacific Bell through joint marketing activities.⁵

11 Q. WHAT CONCLUSIONS HAVE YOU DRAWN WITH RESPECT TO PBCOM’S
12 PROPOSAL?

13 A. The entry of independently operating entities into the California market for telephone
14 services should evolve to the benefit of the subscriber population. The PBCom proposal
15 does not conform with this, however. Instead, as explained below, and by my colleague
16 Mr. Catlin, who will provide detailed supporting testimony, PBCom should be viewed
17 along with Pacific Bell as two arms extending from a single body. The two firms will be

¹Application, para. 16.

²Application, p. 2.

³Response to the Coalition’s Third Set of Data Requests to Pacific Bell Communications,
Data Response 23.

⁴Ibid., 32 and 33.

⁵Ibid., 16.

1 acting in concert, both drawing extensively on the Pacific Bell position as a monopoly
2 provider of regulated local services. Although the technical requirement for separate
3 corporations has been met, the structure of the relationship between Pacific and PBCom
4 does not functionally or operationally satisfy the safeguard requirements of the Act.
5 Another major concern is the collective opportunity and intent of Pacific Bell and
6 PBCom to allow cherry picking by PBCom. That is, Pacific Bell and PBCom intend to
7 allow PBCom to syphon the best, high value customers of Pacific Bell into a non-price
8 regulated affiliate. This would, by design, leave Pacific Bell with the low value
9 customers. Hence, the assertions that PBCom's current lack of market share guarantees
10 that it will not be able to exercise monopoly power are misguided. As proposed, the plan
11 would also allow Pacific to discriminate in favor of its affiliate in the provision of
12 services and information. This is inconsistent with the non-discrimination provisions of
13 the Act and inconsistent with the policy goal of promoting the competitive outcome.

14 Q. HOW DO YOU PROPOSE THAT THE COMMISSION PROCEED WITH THE
15 PBCOM APPLICATION?

16 A. I propose that PBCom be viewed as an extension of Pacific Bell. Historically, local
17 services and long distance services were structurally separated for pro-competitive
18 reasons. Incumbent local exchange carriers (LECs) were denied entry into the interstate
19 long distance market. The Act seeks to provide a mechanism for structural separation
20 and other safeguards for the in-region entry of the LECs into the long distance market in
21 order to ensure a pro-competitive transition in the evolving market for
22 telecommunications services. The intent of the separation and other safeguards of the Act
23 is to ensure an outcome that will be consistent with the transitional intent to separate local
24 and long distance services of the LEC. Therefore, given the plans and intent of PBCom

1 and Pacific Bell as documented in Mr. Catlin's testimony, I recommend that the CPUC
2 restrict the proposed activities of PBCom and Pacific Bell. Specifically, I recommend
3 that PBCom be allowed to market the local services of its affiliates, but that PBCom not
4 be allowed to provide local telecommunications services as a reseller or facilities-based
5 carrier. The intended separation safeguards of Act are clear. The Act does not address
6 the issue of "provision" of local service by an affiliate required under Section 272 of the
7 Act. Although the Act does not expressly address that issue, the intent of the Act is clear
8 in separating the LEC's local service function from the entry into the in-region
9 interexchange function, at least during the initial three-year period.

10 However, if the Commission adopts an interpretation of the Act which allows PBCom to
11 become a "provider" of local services, (as opposed to a marketer of those services for its
12 affiliate) then PBCom should be restricted to being a reseller and not a facilities-based
13 provider.

14 PBCom should be viewed as a monopoly carrier of local service and regulated as such.
15 PBCom is not a competitor of Pacific Bell. Instead, the PBCom proposal is premised on
16 close coordination with Pacific Bell. Unless PBCom is regulated as a monopolistic
17 carrier of local services, Pacific Bell will be able to sell its services pursuant to two
18 different sets of regulatory requirements, depending on which affiliate provides them.
19 Pacific Bell will then be able to circumvent the Commission's requirements regarding
20 Category I and Category II services and the separation intent of the Act.

21 If PBCom is allowed to provide local service as a reseller, PBCom's activities in this
22 market should be subject to the same regulations as is Pacific, as it regards pricing

1 flexibility, bundling and contracting, geographic deaveraging, imputation and other
2 regulations.

3 Q. HAVE YOU ANY RECOMMENDATIONS REGARDING THE APPROPRIATE
4 REGULATION OF PACIFIC BELL IN LIGHT OF THE PBCOM APPLICATION?

5 A. Yes. As noted, the PBCom application is premised on a close cooperation with Pacific
6 Bell. For instance, Pacific Bell intends to joint market PBCom interLATA services.
7 Joint marketing is allowed by the Act, and need not be anticompetitive. The concern,
8 however, is with Pacific Bell's unique position in the local service market and how the
9 joint marketing is accomplished. Pacific should not be permitted to draw upon its
10 position as a monopoly provider of regulated services in marketing interLATA services.
11 Similarly, Pacific Bell plans to use its proprietary customer data to promote, market and
12 sell the interLATA services of its affiliate. This information is not available to other
13 entities from any other source and Pacific Bell plans to use it exclusively for the benefit
14 of its affiliate. It is the initial monopoly position of Pacific Bell in local services that is
15 of concern here. A Pacific Bell/PBCom consortium would have an unwarranted and
16 anticompetitive advantage in this market. Firms more efficient than Pacific in marketing
17 the service and/or more efficient than PBCom in producing the service will be deterred
18 from entering or will have a diminished presence in the market.

1 **III. THE PBCOM PROPOSAL DOES NOT SATISFY THE PROCOMPETITIVE**
2 **GOALS OF THE TELECOMMUNICATIONS ACT OF 1996**

3 Q. WHAT EFFICIENCY RESULTS ARE ASSOCIATED WITH THE OPERATION OF
4 COMPETITIVELY FUNCTIONING MARKETS?

5 A. A competitive market provides both the economically and politically preferred solution to
6 the economic questions of what to produce and how to produce it. A competitive market
7 is characterized by a sufficient number of market participants acting independently so that
8 no market participant can dictate price, quantity, or quality of service. This market
9 structure yields important operational and allocative efficiencies.

10 Operational efficiencies result when the lowest cost method is used to produce the goods
11 or services in question. Competition ensures this result. New entrants are free to adopt
12 the least cost method available. Since market price is forced downward as new entrants
13 increase supply, inefficient producers are forced to adapt to more efficient methods or
14 cease production.

15 Allocative efficiency results when society's resources are channeled into the production
16 of goods and services valued more highly than the resources used in their production.
17 Since total resources are limited, it is in society's interest to have these resources used in
18 a way that maximizes the value of what is produced with those resources. The
19 competitive market allocates resources efficiently, that is to the most valued uses.

20 Q. IN WHAT CIRCUMSTANCES IS REGULATION AN APPROPRIATE
21 ALTERNATIVE TO A FREELY FUNCTIONING MARKET?

1 A. Regulation is appropriate when a competitive outcome is not likely. This is typically the
2 case when the market is characterized as natural monopoly, where economies of scale and
3 scope justify the existence of a limited number, possibly even one, participant. If left
4 unregulated, firms operating under these conditions can benefit by restricting output,
5 raising price and gaining profits not available in competitive market arrangements. The
6 purpose of regulation is to ensure that the regulated entity does not operate in a manner
7 that reflects unchecked market power.

8 Q. ARE THE CONCEPTS OF OPERATIONAL AND ALLOCATIVE EFFICIENCIES
9 IMPORTANT TO THE REGULATED SECTOR OF THE ECONOMY?

10 A. Yes. It is an accepted principal that regulation is an alternative mechanism to achieving
11 the competitive market outcome. The regulated result should, absent other social
12 considerations, serve as a proxy for competitive market results. In this manner, the
13 operational and allocative efficiencies inherent in competitive markets are promoted.

14 In the case of the local exchange market, the incumbents have literally 100 percent of the
15 market and will remain in possession of this share as local competition begins. Carriers
16 are just now building new networks which is a process that will take many years to
17 complete. Local exchange competition is a new phenomena and therefore it cannot be
18 known with certainty what will be the outcome associated with opening local markets. It
19 is important to recognize the absence or presence of competition in determining the
20 regulatory policy.

21 Q. WILL THE ENTRY OF AN ADDITIONAL PARTICIPANT IN A MARKET
22 INCREASE THE LEVEL OR INTENSITY OF COMPETITION IN THAT MARKET?

1 A. Often, but not necessarily. Recognize that competition requires independent action by
2 market participants. This must be in the form of each market participant striving
3 independently for patronage and the associated revenues and profits. Regardless of the
4 number of market participants, there should not be unfair, exclusionary or harmful
5 discriminatory tactics if the competitive outcome is to be achieved. By acting
6 independently, market participants' actions toward each other are nondiscriminatory.⁶ It
7 is this independence that the separate subsidiary requirement of the Act sought.

8 Q. ARE THERE SPECIAL CONCERNS AS A MARKET EVOLVES FROM ONE THAT
9 IS PRIMARILY MONOPOLISTIC IN NATURE TO ONE THAT IS INCREASINGLY
10 COMPETITIVE?

11 A. Yes. Recognizing that competition is evolving means that competition will vary across
12 services, market segments and time. Markets should be subject to regulation and to
13 freedom from regulation based on the relative degree of market power experienced at the
14 time.

15 In a variety of market settings, dominant firms have an incentive to engage in strategic
16 actions that disadvantage producer's of related products in upstream or downstream
17 markets. The strategic actions establish barriers that serve to retard entry into or exit
18 from those markets. As a result, companies more efficient than the incumbent will be
19 precluded from entering the market, forced to exit the market, or otherwise retain a
20 diminished market share. Market power, rather than operating efficiencies or consumer
21 preferences, determine market share. The federal and state policies of promoting

⁶Scherer and Ross, Industrial Market Structure and Economic Performance, 3rd edition, Houghton Mifflin, Boston (1990), page 53.

1 competition are thwarted in that the probability of an efficient competitive market
2 outcome is diminished.

3 Q. WHAT IS THE IMPORTANCE OF ESTABLISHING SAFEGUARDS IN MARKETS
4 THAT ARE NOT YET COMPETITIVE?

5 A. The desire to promote competition where it is emerging and for markets that are
6 competitive to remain so, or not be monopolized (or remonopolized) by discriminatory or
7 other anticompetitive actions on the part of the incumbent, recognize the loss in social
8 welfare that would result from such anticompetitive activity. If a market were still
9 noncompetitive, and discriminatory or other noncompetitive actions by the LEC impeded
10 the development of competition, similar losses in social welfare would result. Stated
11 differently, the loss of social welfare from preventing the successful emergence of
12 competition, is similar to the loss of social welfare from the monopolization of that same
13 market. The Commission's policy should reflect this goal of encouraging the
14 development of competition where consistent with the public interest.

15 Where competition is evolving, there will be more than one market participant. The
16 incumbent may retain market power, at least transitionally. The monopoly classification
17 applies to firms that have significant or substantial market power; whether through
18 natural monopoly or legal/regulatory barriers. Other firms would be subject to less, if
19 any, regulation based on the degree of market power. A regulatory structure recognizing
20 this difference has been used by the CPUC as well as the FCC in its regulation of AT&T.
21 In California, the Commission established different reporting requirements for
22 "dominant" and "competitive" market participants in Docket 93-02-019. Similarly, in
23 Docket 89-10-031, the Commission adopted a framework which included varying

1 degrees of pricing flexibility for Pacific's and GTE's services depending on the degree of
2 competition. At that time, the Commission established three categories of local exchange
3 carrier (LEC) services which differ primarily on the extent of market competition; and the
4 level of pricing flexibility varied accordingly. Finally, in the Commission's recent order
5 on pricing flexibility for local exchange services, the Commission found that "Pacific and
6 GTEC possess dominant market power in their local exchange market even though legal
7 barriers to market entry have been lifted" and, that "Stronger regulatory requirements for
8 the LECs compared to the CLCs is warranted by the current market dominance of the
9 LECs compared to CLCs and promotes the goal of overall regulatory symmetry."⁷

10 Q. WHY IS REGULATING PBCOM AS A MONOPOLY PROVIDER OF LOCAL
11 SERVICES APPROPRIATE?

12 A. If the Commission determines that PBCom can be a provider of local services, the degree
13 of oversight and, thus, the degree of flexibility allowed can and should be related to the
14 degree of competition faced in the provision of each service. The passage of an order
15 lifting one of the restrictions or entry barriers to a market or the technical satisfaction of
16 selected safeguard rules does not automatically make any market competitive or, in this
17 case, ensure that the market will effectively regulate any of the services of
18 PBCom/Pacific. As noted, facilities-based competition is just evolving and will likely
19 take some years to fully develop.

20 It is not the market share of PBCom which creates the anticompetitive concerns of the
21 plan. It is the ability of PBCom and Pacific to exploit Pacific's market power and to
22 transfer the high value local customers to an unregulated affiliate that is of concern.

⁷D.96-03-020, FOFs 26 and 81.

1 Many of these services remain subject to the significant monopoly power of Pacific.
2 Therefore, it is appropriate that the Commission adopt a policy which protects the
3 consumers of noncompetitive services whether provided by Pacific or PBCom.

4 Q. WHAT IS THE RELEVANT MARKET TO CONSIDER WHEN DETERMINING
5 WHETHER THERE IS MARKET POWER?

6 A. The analysis involves identifying the dimensions of the market. Economic theory uses
7 substitutability as the relevant criterion -- all products/services that can with some ease
8 and at approximately the same cost be substituted for the one in question constitute a
9 single market. This applies to products/services directly consumed by end users as well
10 as others, such as carrier access, which are used as inputs in a production process. In
11 addition, it considers both the product and geographic scope of substitutability.

12 The relevant market is that for local services. Recognize first, that the market for local
13 and interLATA services are separate and distinctively different. A decrease in the price
14 of local services is not likely to convince a customer to make a local call instead of an
15 interLATA call. Generally, the facilities used to transport an interLATA call cannot be
16 converted to local calling. Hence, local and interLATA calling are not substitutes, they
17 constitute different markets.

18 Further, the concerns are stimulated by market power with regard to local services, that is
19 in the market for local services. There would be many fewer issues with regard to
20 PBCom regulation, if it applied to provide interLATA service only.

1 Q. WHAT ARE THE KEY PROVISIONS OF THE ACT REGARDING THE PROVISION
2 OF IN-REGION INTERLATA SERVICES BY A BELL OPERATING COMPANY?

3 A. Section 272 of the Act generally imposes safeguards including a separate subsidiary
4 requirement on any Bell operating company which is subject to Section 251(c)
5 (Additional Obligations of Incumbent LECs.)⁸ Section 272(a)(1) allows a Bell operating
6 company to provide in-region interLATA service only if (1) it provides that service
7 through one or more affiliates that are separate from the operating company subject to
8 Section 251(c) and (2) which meet the list of structural and transactional separation rules
9 required in Section 272(b). Additionally, Section 272(c) prohibits the Bell operating
10 company from discriminating between its Section 272 affiliate and any other entity in the
11 provision or procurement of goods, services, facilities, and information, or in the
12 establishment of standards. Section 272(d) requires a biennial audit and Section 272(g)
13 imposes restrictions on joint marketing. Section 272(e) adds additional requirements
14 which tighten the anti-discrimination safeguards. These safeguards are intended to
15 prevent the Bell operating companies or their affiliates from engaging in anti-competitive
16 behavior as entry occurs and competition evolves. The large number of safeguards
17 including the separate subsidiary requirement, and the detail of the transactional
18 requirements attest to Congress' antitrust concerns.

19 Q. DOES THE LEGISLATIVE HISTORY OF THE ACT SUPPORT THIS VIEW?

20 A. Yes. For example, consider the concern stated in the Senate Report:

21 This legislation authorizes the BOCs to engage in the ... provision
22 of long distance service under certain conditions. The bill would
23 replace the current antitrust prohibition with regulatory safeguards

⁸See Mr. Catlin's testimony for a more detailed discussion of the implications of Section 272 of the Act.

1 designed to prevent the BOCs from engaging in anti-competitive
2 behavior.⁹

3 As this makes clear, the potential for anti-competitive behavior by the incumbent LECs
4 was a major concern in opening the in-region interLATA market to the BOCs. The report
5 goes on to state that the overall purpose of the bill is to increase competition in all
6 telecommunications markets.¹⁰ The goals of the Act are not achieved unless the structure
7 of the proposed affiliate relationship ensures that the intended safeguards are met.

8 Q. DOES THE STRUCTURE OF THE PROPOSED PBCOM AFFILIATE MEET THESE
9 REQUIREMENTS?

10 A. No. The proposed structure and the transactional relationship between Pacific and its
11 affiliate, PBCom, does not provide sufficient protection against discrimination or the
12 exercise of monopoly power which the Act is intended to prevent. The proposed
13 transactional relationship and concerns regarding the failure to disclose certain
14 agreements or plans is fully discussed in the testimony of my associate, Mr. Catlin.

15 Generally, there are at least five concerns with the proposed structure. First, there is a
16 lack of independence of action. PBCom and Pacific are not competitors, but rather are
17 partners in this venture. Second, while a separate facility has been established pursuant to
18 Section 272 of the Act, the safeguards intended will be subverted if PBCom is also able
19 to be a provider of local service. Third, while PBCom claims that it will adhere to the
20 PUC's affiliate transaction rules, these rules were designed to limit monopoly abuse in
21 the context of a rate of return environment, that is, making use of disciplinary actions

⁹Regulatory Impact Statement, Senate Committee on Commerce, Science and Transportation,
p. 15. (Senate Report)

¹⁰*Ibid.*, p. 17, Section 3, "Purpose."

1 unique to a rate of return environment, not in today's changing regulatory environment.

2 Fourth, there is the concern that PBCom will become the provider of Pacific's local
3 service to only or mostly Pacific's high valued, high volume customers to the detriment
4 of the remaining customers of the regulated entity. Fifth, the safeguards established by
5 this Commission, such as appropriate price floors and imputation, will be subverted.

6 Q. WHAT IS THE NATURE OF THE LACK OF INDEPENDENT ACTION AND ITS
7 IMPLICATIONS?

8 A. The PBCom proposal makes absolutely clear that Pacific Bell and PBCom are two
9 organizations acting as partners seeking to maximize their joint revenues. PBCom will
10 sell Pacific's local service, and Pacific Bell will use its resources to promote PBCom's
11 interLATA services. Further, Pacific used its proprietary information and intellectual
12 property, as well as other documents, in forming the interLATA service provisioning
13 subsidiary, PBCom.¹¹ Pacific also plans to access its proprietary customer information
14 data base (with the verbal consent of the customer) as part of its effort to promote the
15 PBCom interLATA product. Plus, as documented in Mr. Catlin's testimony, it is the
16 intent of both parties to direct Pacific's best customers to the unregulated affiliate. These
17 activities cannot be described as an attempt to maximize the profits of PBCom or,
18 alternatively, to maximize the profits of Pacific Bell. Instead, they can only be described
19 as attempts to maximize the joint revenues and joint profits of these organizations
20 collectively.

21 The absence of an independent action means that for market analysis purposes, PBCom is
22 little more than an extension of Pacific Bell. Hence, PBCom is able to take advantage of

¹¹Response to the Coalition's Third Set of Data Requests to PBCom, Response 23.

1 any market power possessed by Pacific Bell. As such, if customers are to be protected
2 from monopoly abuse, PBCom should be prohibited from providing the local service of
3 Pacific, or in the alternative, should be subject to the same regulatory rules and regulatory
4 restrictions as is Pacific Bell.

5 Q. WHAT ARE YOUR CONCERNS WITH REGARD TO THE TRANSACTION
6 RELATIONS BETWEEN PBCOM AND PACIFIC BELL?

7 A. PBCom claims that it will adhere to the PUC's affiliate transaction rules. Mr. Silacci, for
8 instance, discusses these rules and PBCom's proposed compliance.¹² The Commission's
9 policies with regard to affiliate relations were put into place as a result of earlier
10 investigations, and were designed to take advantage of the disciplinary actions inherent in
11 rate of return regulation. As explained by Mr. Catlin, these rules focus on transfer pricing
12 and internal cost allocation issues, matters relevant to rate of return regulation. These
13 rules did not focus on concerns relevant to increasing competition.

14 Q. PLEASE EXPLAIN YOUR CONCERNS REGARDING THE ADEQUACY OF A
15 SEPARATE SUBSIDIARY REQUIREMENT.

16 A. It must be recognized that the separate subsidiary requirement is the means to an end, not
17 an end in and of itself. The purpose of the requirement is to promote independent action.
18 If successful, the requirement would have each of the individual subsidiaries undertaking
19 actions based upon its own best interests. The purpose is to distinguish between
20 separateness and jointness.

¹²Direct Testimony of Michael L. Silacci, pp. 6-11.

1 Consequently, there is no concern about the separate subsidiary requirement, as long as it
2 results in a truly separate and independent functioning organization. In this instance,
3 separation is to keep the provision of interLATA services separate from local services, at
4 least until competition successfully emerges in the market for local services.

5 The concept of separateness will be lost, however, if PBCom is allowed to provide local
6 services in the interim. The goal of separating the production and provision of
7 interLATA and local services until competition successfully emerges in the market for
8 local services is lost.

9 Q. WHAT ARE YOUR CONCERNS WITH RESPECT TO THE ABILITY OF PBCOM
10 TO SYPHON PACIFIC BELL'S BEST CUSTOMERS?

11 A. As discussed above, the concern is that certain customers will be strategically moved to
12 an unregulated affiliate, thereby bypassing the Commission's regulation of certain
13 services and allowing the two affiliates to engage in activities which are designed to
14 maximize the collective profits of the organization without regard to the interests of the
15 regulated utility's customers.

16 Q. THE VERY EXISTENCE OF PBCOM RESTS ON THE SECTION 271 CHECK LIST
17 REQUIREMENTS BEING MET. DOES THAT NOT SUGGEST THAT THERE IS
18 ADEQUATE COMPETITION IN THE MARKET FOR LOCAL SERVICES?

19 A. No. While counsel will address the legal implications, from an economic perspective, it
20 is more reasonable to interpret the Act as indicating that competition in the market for
21 local services has begun to emerge. I agree with this concept that the appropriate method
22 of measuring the extent to which competition does exist in the market for local services is